

LATIN LAWYER REFERENCE MERGERS AND ACQUISITIONS 2019

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# Ecuador

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## **1 Has the level of M&A activity slowed, increased or remained flat in 2018 as compared to 2017, and what are conditions like today? In general terms, what level of activity is foreseen for 2019? What are the factors influencing the level of M&A activity – Economic? Political? Commodity prices? Weakness in currency? Stock market performance? Liquidity? Rule of law? Other?**

The level of M&A activity in 2018 increased greatly in comparison to 2017 despite the economic crisis that Ecuador is undergoing caused by the oil price drop in the previous years and excess foreign debt acquired by the government.

The current President has been working on solutions to decrease the economic crisis. Some of these regulatory solutions include tax exemptions and incentives aimed at attracting more foreign investment.

Private companies short on cash and seeking liquidity have opened up to the idea of looking for an investor party and contemplating selling their businesses as bailouts or even divesting from one or several business units through carveouts. Transnational companies and foreign investment funds have also pursued exit strategies in the Ecuadorian parts of their businesses, as a way to recuperate their investments from new eager investors who wish to try to turn them around.

On the other hand, many multinationals have looked at various industries in Ecuador as investment targets taking into consideration that other countries in the region have already been invested in as they have been viewed as traditional investment countries.

The government has also become a notable player in the M&A sector, as it has and will be looking for financing for its state companies. The Foreign Commerce Minister has been very active internationally publicising potential investment ventures in Ecuador. This has encouraged the government to create new venture possibilities by selling stakes in their state companies or state subsidiaries, located mostly in developing strategic sectors such as oil, gas, energy, telecoms, transportation and media.

## **2 Which industries do you expect will see the most M&A activity in 2019?**

The energy and oil and gas sectors will remain active in M&A. Even with the low oil prices this sector foresees investment opportunities in the development of energy facilities and oil blocks. Last year, Ecuador's national oil company promoted the public bid for the development of new oil fields. A consolidation in the insurance and banking sectors is a possibility, as well as many restructurings in retail, construction media and education.

The government also enacted in August 2018 an Investment Promotions Law (Ley Orgánica para el Fomento Productivo, Atracción de Inversiones, Generación de Empleo y Estabilidad y Equilibrio Fiscal) set out to promote new investments by incorporating tax exemptions and incentives amongst other reforms design to make the country more attractive. Among the incentives are a strict capital gains tax (no longer variable) on the transfer of capital rights, and eight to 15 years corporate income tax exemptions on new investments carried, depending on the region where the investment is located.

## **3 What types of deals do you expect to see?**

Acquisitions of shares and equity interests are usual in Ecuador. It is also common to make considerable stock purchases in such operations, which give the acquirer control of the company (or companies) concerned. The volume of mergers is lower because mergers entail regulatory and corporative steps and procedures that may take several months. There is also a low level of productive asset acquisitions.

In relation to share purchases, as of August 2018 the Republic of Ecuador passed an amendment to the capital gains tax, which included a maximum tax rate of 10 per cent on direct and indirect share transfers.

## **4 Discuss the level of M&A activity you have seen over 2018 and expect to see in 2019 of: (i) pure domestic deals; (ii) deals in your jurisdiction involving a domestic target and foreign acquirer from Latin America, or a foreign acquirer from outside Latin America; and (iii) deals involving a domestic acquirer and foreign target in Latin America or a foreign target outside Latin America.**

Although we have seen some purely domestic deals in the tech, energy and agricultural sectors, there have been very few of them. Most activity that will probably pick up this year are M&A deals centred heavily on real estate, manufacturing and retail. Deals involving foreign acquirers have dominated M&A activity in Ecuador and it is quite possible that they will continue to do so as foreign corporate groups in 2019 will seek to seize opportunities from the crisis. As for deals involving an Ecuadorian acquirer of foreign companies, there were few of them in 2018 and their activity in 2019 will depend on governmental regulations to encourage in Ecuador as opposed to other countries in the region.

## **5 What is the level of private equity activity? Are domestic or international funds involved? What kinds of deals are they doing?**

We have seen moderate activity from foreign equity funds, either solo or accompanying private corporate groups as the funding partners, mainly in the energy and natural resources sector. International funds have been involved utmost in transactions relating to energy, natural resources and infrastructure targets. Still, ordinarily fund activity is still pretty limited as against to the activity seen in neighbouring countries. There are few strong local funds, however they were active last year and it is likely that they will increase their activity this year seeking new opportunities with the potential abolishment of regulations.

## **6 Is acquisition financing available for deals? Where is financing coming from? How much concern do you have that an increase in interest rates or risk of a recession will limit the availability of financing?**

There has been no textbook acquisition financing but variations adapted to the Ecuadorian reality that may in some cases relate more to project financing. The “country risk” has not made deals in Ecuador as attractive as in other jurisdictions. Also, local financing entities have reduced their financing activity due to the lack of liquidity created by the economic crisis. Most of the financing seen has come from multilaterals. Deals with the state, for example, have been more prone to have an acquisition financing component and access to multilaterals. Overall, however, most acquisition financing seen has been in energy and natural resources deals.

## **7 How open is your country to investments and acquisitions by foreign buyers? Is there a level playing field when foreign and domestic bidders compete to buy the same domestic target company?**

The Ecuadorian government has tried to make investments in Ecuador more attractive to foreign and local investors alike by enacting laws and regulations with tax holidays and legal benefits throughout these past couple of years. Among these benefits is the possibility of executing an investment protection agreement with the Ecuadorian government that allows any controversy to be disputed through international arbitration. In the first quarter of 2017, Ecuador denounced all executed bilateral investment protection treaties and communicated its intentions to terminate them. Ecuador is currently negotiating new BITs; however, the denouncement has increased the country’s investment risk abroad.

While there are regulatory compliance requirements for certain strategic acquisitions (such as the standard anti-trust clearance or change of control authorisations), there are very few hard restrictions imposed on foreign investments. The most notable restriction lies in the media sector, where foreigners who do not reside in countries with economic development treaties with Ecuador are forbidden from acquiring local media companies.

## **8 Are corruption and compliance concerns affecting M&A activity? Are there industries where this is a particular issue?**

Compliance requirements have become more popular in Ecuador, especially considering the amount of new foreign investors entering the scene, which seek to adapt local compliance regulations to the most notable FCPA or UK Bribery Act standards.

Also, Ecuador has seen its share of corruption scandals in the past couple of years, ranging from events occurring in state companies to international scandals from private companies on a global scale that end up having an impact in the country. One of this new presidency’s flagship plans has been to prosecute public and private entities involved in corruption scandals.

These events have raised awareness of anti-corruption and money laundering compliance in due diligence works, as well as the inclusion of specific provisions in SPAs in these regards, and continued advice throughout the closing process. In any M&A process, representing national or international clients, currently any major M&A practice is complemented with compliance experts with relevant international experience.

## **9 How big a part of M&A activity is the restructuring of financially troubled companies? Have you seen more of this in 2018 as compared with 2017? What are the prospects for 2019?**

In comparison with recent years, we can say that we have seen saw more deals of companies seeking funds, or an exit strategy from a troubled economic country in comparison to previous years. While there have not been any deals involving companies declared in bankruptcy per se, there have been bailouts of distressed companies. This has proven more common in the flower sector and oil-related industries.

The lack of cash flow in the country has placed many companies in a distressed condition. Obtaining financing from local banks has proved difficult since it is fixed at high interest rates in comparison with the financing that may be obtained in international markets. International financing entities are more prone to lend financing; however, the risks involving investing in the country have made them weary and cautious compared to the activity seen in neighbouring countries. This means that in 2019 we will probably continue to see a great deal of transactions involving restructuring of financially troubled companies. Given the constrictions in obtaining financing, this may be a great opportunity for high-risk investment funds to enter the scene.

## **10 Does your country's bankruptcy law permit the reorganisation of the debtor as a going concern, and the acquisition of the entity out of bankruptcy? Are you seeing much activity in this area?**

There have not been many companies declared bankrupt in recent years as the Concordat Law is antiquated and difficult to execute. That being said, there are no specific restrictions on the sale of shares of formally declared bankrupt companies. However, considering that the law imposes restrictions on the company's dealings with its assets, this could be interpreted by tribunals as extending to its shares as well. Thus, permission on reorganisation would boil down to the acquiescence of the company's creditors.

## **11 Has there been any increase in public company M&A?**

Ecuador's listed public scene is not as active as in other countries in the region. While the government has tried to include certain regulatory and tax benefits in activities involving publicly listed companies, these attempts have been too feeble to counter the general lack of trust of locals and foreigners in Ecuador's capital markets. As such we have seen that the activity in public company M&A has remained stable over the years.

## **12 How well protected are minority shareholders in public companies? What recent developments have there been as relates to independent directors, special committees, independent advisers, fairness opinions?**

Ecuadorian legislation has not developed minority shareholders' protection measures further than the basic rights provided in the Companies Law. The law grants the following specific rights and protections to minority shareholders that individually or jointly have 25 per cent or more of a stake in a company: (i) the right to challenge any of the company's administration bodies' resolutions that they deem have been approved in prejudice of the company or of them; (ii) the right to compel the administration to summon a general shareholders' meeting; (iii) the right to choose one Corporate Comptroller (Comisario) (akin to an internal, independent, auditor) when the company has three or more commissioners in place; and (iv) the right to compel the company to remove the chosen liquidator in the event of a liquidation of the company.

## **13 Has there been any increase in shareholder activism and hostile takeovers? Are international hedge funds active in your market? What defences are target companies permitted to adopt?**

There are two important developments worth mentioning.

The first is not fairly recent but relevant to M&A. On 29 December 2014 the government enacted the Production Incentive and Tax Fraud Prevention Organic law, which introduced payment of capital gains for any direct or indirect sale of shares or capital representative rights (ie, concession rights) of an Ecuadorian special purpose vehicle. Even though the law states that the capital gains must be paid by the seller, if it to do so the law also stated that the Ecuadorian vehicle shall bear the payment as a "substitute payer". This means that if the seller fails to comply with its obligations, the buyer will be stuck with an additional economic burden.

The second development is fairly recent. In August 2018, the government enacted the Investment Promotions Law, which created a fixed capital gains tax reducing its maximum tax rate from 22 to 10 per cent. This will surely increase the activity between shareholders in the upcoming years.

**14 Have directors, management and controlling shareholders changed how they conduct themselves in M&A deals? What kind of fiduciary duties do directors, management and controlling shareholders have under the laws of your jurisdiction? From your experience, are directors, management and controlling shareholders more diligent today in their review of M&A transactions and other matters?**

Besides the standard good faith, loyalty and care duties in the day-to-day running of the company and any other duty that may be specifically included in a company's articles of incorporation, there are no other special obligations imposed on management bodies in M&A deals. Shareholders do not have any special fiduciary duties under Ecuadorian law. Thus, actions and attitude of management and shareholders have remained pretty much the same.

**15 Should directors, management and controlling shareholders be more concerned today about negative publicity, shareholder criticism, regulatory pressure, shareholder lawsuits and liability from potential litigation?**

Shareholders and management have become more aware of criticism and regulatory pressure in deals where there are changes of control regulatory requirements. Historically in Ecuador this has been a hot topic, with many high-profile cases where compliance with these regulations have been debated and substantial compensation for damages has been claimed.

Ordinarily management who have the legal representation of the target company are legally liable for any breach of laws by the company, such as change of control. This has caused all parties in a deal to have carefully consider the regulatory aspects of a transaction.

**16 Are there major differences in how domestic and cross-border deals are being conducted? For instance, does the type of purchase agreement used in your jurisdiction differ significantly from the international style of agreement? If so, which type is being used more often?**

The gap between local and international M&A differences has narrowed down during the past few years. Deals involving local or foreign parties alike have adopted more and more UK and US M&A standards. Transaction documents such as SPAs are now drafted in accordance with their house style, including sections such as representations and warranties and disclosure schedules, which is something that was not very common under the civil law regime.

Even though the civil, commercial codes and other ancillary legislation already regulate key parts of a transaction (such as which types of compensation is recognised under Ecuadorian law), this has not stopped parties from including specific contractual regulations in the documents as this would happen in other jurisdictions.

**17 Have there been changes in the process for how M&A transactions are conducted in your jurisdiction?**

M&A deals in Ecuador have become more sophisticated, matching international standards. M&A transactions are usually conducted applying best practices and trends and technological support.

**18 How level is the playing field for domestic and international bidders?**

Multinational buyers have less risk aversion than local ones, probably from their experience of dealing in many jurisdictions. Still, there are many legal risks that are difficult to avoid and assume for foreigners and locals alike, such as environmental and social security liabilities. Ecuadorian law states that these two liabilities have no statute of limitations. On the other hand, international buyers have less tolerance for compliance issues than local parties. In all of these cases we have seen strong indemnity provisions in the transaction documents.

**19 For international buyers and investors looking at deals in your jurisdiction, what are the three most important pieces of advice you have and what are the three most important pitfalls that should be avoided?**

Ecuador may be seen as a simpler jurisdiction compared to its neighbours; however, its regulatory laws may in some cases be more complex. Underestimating the regulatory hurdles that the transaction must undergo may place parties in a tight spot, even trigger indemnities. Specially since certain regulatory requirements (such as anti-trust clearings) may take longer than in other

jurisdictions. Therefore, our first recommendation would be to have a clear picture of how the transaction will have to develop, and the timing that clearing each requirement will take in order to manage expectations.

Regulatory complexity is especially true in tax matters. Ecuador's tax law has tax penalties if a buyer uses vehicles incorporated in jurisdictions identified as tax havens by the Ecuadorian IRS. This applies even to the capital gains that must be paid in a share purchase transaction. Thus, our second recommendation would be to have a clear tax structure for the transaction in order to maximise tax efficiencies in the deal, and operations of the target company afterwards.

Negotiation on robust indemnity mechanisms are a must. Ecuadorian law states that social security and environmental liabilities do not have a statute of limitations. When it comes to environmental liabilities, these may be cumbersome and difficult to assume. Obtaining compensation for these liabilities by triggering the transaction provisions may take some time. Thus, indemnity mechanisms (such as escrows or price discounts) may aid in remedying said liabilities.

## **20 Have there been any significant regulatory developments affecting M&A – your country's securities exchange commission, antitrust regulators, tax authorities, Central Bank, other regulators that review deals etc?**

There are two important developments worth mentioning.

On 29 December 2017, the government enacted the Economy Reactivation, Dollarisation Robustness and Financial Management Modernisation Organic Law. To maintain a steady flow of public fund income, the law increases the corporate income tax rate from 22 per cent to 25 per cent for any company that generated revenue greater than US\$4300,000. Penalties imposed on investments from tax havens now increase the corporate income tax rate from 25 per cent to 28 per cent.

On the other hand, the Investment Promotions Law provided a moratorium for companies and individuals to pay any pending or outstanding taxes at a discounted rate, income tax rate and currency remittance tax exemptions on new investments and a reduction of the capital gains tax



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Martín Pallares Sevilla is partner at Ferrere in Ecuador and focuses on cross-border transactions with an emphasis on M&A and public procurement, with particular prominence of the energy and natural resources sector.

Prior to joining Ferrere, he worked as a senior associate at a major law firms in Ecuador, advising international clients with major project investments in Ecuador.

Martín's practice began at DLA Piper's Madrid office, where he worked as an associate of the real estate department for several years. His main focus was cross-border real estate transactions, and coordinating corporate, financing and tax matters. Furthermore, he advised the largest credit entities in Spain on debt restructuring and asset for debt swap operations, and on a variety of financing transactions.

He obtained his LLB from the University of Salamanca, and a master's in Law (LLM) from the Superior Law and Economics Institute, graduating among the top 10 students in his class. Martín also obtained a master's degree in business administration (MBA) from the Financial Studies Center (CEF) and from the Universidad a Distancia de Madrid (UDIMA), with a partial scholarship from DLA Piper.

Martín is a member of the Illustrious Madrid Bar Association, and has been recognised as a ranked lawyer by *Chambers Global*.



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Daniel Robalino Orellana is partner at Ferrere and his practice focuses on antitrust and regulatory economic law matters, as well as on foreign investment planning and foreign trade. Additionally, Daniel has been actively involved in international arbitration practice, both on investment and commercial disputes, under CIADI and UNCITRAL rules.

Since 2011, upon passage of the Organic Law for Regulation and Control of Market Power (Antitrust Law), he has advised national and international clients on litigation involving competition, cease commitments, mergers and acquisitions subject to prior control, and planning and implementation of compliance programs. He has led cases related to a variety of industries, including: agribusiness, food and drink, aviation, banking, cement, construction, pharmaceutical, franchises, oil (upstream and downstream), press, advertising, retail, reinsurance, telecommunications and vehicles, among others.

Before joining the Ferrere team Daniel worked for one of Ecuador's top law firms, where he directed the economic law practice. Since 2013 he has been recognised by The Legal 500 for his solid knowledge of the Ecuadorian market and his dedication.

He is included on the list arbitration Secretaries of the Arbitration and Mediation Centre of the Ecuador-American Chamber of Commerce (AMCHAM) in Quito, and sits on the boards of directors of renowned companies with operations in Ecuador.

Daniel has published research in national and international reviews, and was assistant professor in Theory of Proof and General Theory of Obligations at Universidad San Francisco de Quito and Pontificia Universidad Católica del Ecuador, respectively. Since 2014 he has trained the Arbitration Team of Universidad del Azuay for the International Arbitration Competition organised annually by University of Buenos Aires.

He studied law at the San Francisco University of Quito (Ecuador) and graduated as a lawyer in 2010. He obtained a postgraduate diploma in competition law from The College of Law of England and Wales in 2011. That same year he participated in the Academy of American and International Law sponsored by the Southwestern Institute for International and Comparative Law, in Dallas, United States. In 2018, he earned an LLM from Northwestern University Pritzker School of Law (Chicago).

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